

RLI INSURANCE COMPANY

Statutory Financial Statements and Schedules

December 31, 2009 and 2008

(With Independent Auditors' Report Thereon)



KPMG LLP
303 East Wacker Drive
Chicago, IL 60601-5212

Independent Auditors' Report

The Audit Committee of the Board of Directors of RLI Corp.
The Board of Directors of Mt. Hawley Insurance Company:

We have audited the accompanying statutory statements of admitted assets, liabilities, and capital and surplus of Mt. Hawley Insurance Company (the Company) as of December 31, 2009 and 2008, and the related statutory statements of income and changes in capital and surplus, and cash flow for the years then ended. These statutory financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these statutory financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described more fully in note 1 to the statutory financial statements, the Company prepared these statutory financial statements using accounting practices prescribed or permitted by the Illinois Department of Insurance which practices differ from U.S. generally accepted accounting principles. The effects on the financial statements of the variances between the statutory basis of accounting and U.S. generally accepted accounting principles also are described in note 1.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the statutory financial statements referred to above do not present fairly, in conformity with U.S. generally accepted accounting principles, the financial position of the Company as of December 31, 2009 and 2008, or the results of its operations or its cash flows for the years then ended.

Also, in our opinion, the statutory financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and capital and surplus of the Company as of December 31, 2009 and 2008, and the results of its operations and its cash flow for the years then ended, on the basis of accounting described in note 1.

As discussed in note 1 to the statutory financial statements, the Company changed its method of accounting for deferred taxes in 2009.



Our audits were made for the purpose of forming an opinion on the basic statutory financial statements taken as a whole. The supplementary information included on the schedule of supplemental investment risk interrogatories, the summary investment schedule, and the supplemental schedule of reinsurance interrogatories is presented for purposes of additional analysis and is not a required part of the basic statutory financial statements. Such information has been subjected to the auditing procedures applied in the audits of the basic statutory financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic statutory financial statements taken as a whole.

KPMG LLP

May 25, 2010

RLI INSURANCE COMPANY

Statutory Statements of Admitted Assets, Liabilities, and Capital and Surplus

December 31, 2009 and 2008

Admitted Assets	2009	2008
Bonds	\$ 555,772,021	473,418,131
Common stocks	176,733,568	165,667,930
Preferred stocks	—	812,800
Investment in affiliates	565,555,042	470,109,432
Real estate occupied by the Company, at cost, less accumulated depreciation of \$9,634,512 and \$8,993,553 in 2009 and 2008, respectively	8,270,110	8,781,991
Cash and short-term investments	54,727,963	56,690,060
Other invested assets	1,000,000	—
Receivable for securities	—	16,925,208
Total cash and invested assets	1,362,058,704	1,192,405,552
Uncollected premiums and agents' balances	45,043,314	45,787,561
Funds held by or deposited with reinsured companies	4,000	4,000
Reinsurance recoverable on paid losses and loss adjustment expenses	4,862,173	6,367,879
Deferred tax asset	6,055,029	18,363,143
Electronic data processing equipment, at cost less accumulated straight-line depreciation of \$16,647,991 and \$24,579,066 in 2009 and 2008, respectively	373,439	617,907
Investment income due and accrued	6,497,019	6,120,428
Receivable from affiliates	—	4,863,045
Other assets	1,917,353	4,544,152
Total admitted assets	\$ 1,426,811,031	1,279,073,667

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Statutory Statements of Admitted Assets, Liabilities, and Capital and Surplus

December 31, 2009 and 2008

Liabilities and Capital and Surplus	2009	2008
Unpaid losses and loss adjustment expenses	\$ 373,115,827	350,305,788
Reinsurance payable on paid losses	235,370	783,841
Accrued expenses	30,312,702	32,299,661
Unearned premiums	153,088,592	148,165,761
Advance premiums	3,922,921	3,785,888
Ceded reinsurance premiums payable	9,831,655	15,421,779
Funds held under reinsurance agreements	779,814	608,919
Amounts withheld	47,344,613	32,095,258
Provision for reinsurance	883,400	838,000
Current federal and foreign income tax recoverable	3,512,672	208,160
Commissions payable, contingent commissions, and other similar charges	13,285,962	13,798,927
Payable to parent	5,763,640	—
Other liabilities	573,015	2,720,516
Total liabilities	642,650,183	601,032,498
Capital and surplus:		
Capital stock, \$125 par value. Authorized 1,000,000 shares; issued and outstanding 80,003 shares	10,000,375	10,000,375
Paid-in contributed capital	242,451,084	242,451,084
Unassigned surplus	531,709,389	425,589,710
Total capital and surplus	784,160,848	678,041,169
Total liabilities and capital and surplus	\$ 1,426,811,031	1,279,073,667

See accompanying notes to statutory financial statements.

RLI INSURANCE COMPANY

Statutory Statements of Income and Changes in Capital and Surplus

Years ended December 31, 2009 and 2008

	2009	2008
Premiums earned	\$ 277,947,449	265,297,702
Losses and underwriting expenses incurred:		
Losses and loss adjustment expenses	128,992,281	117,746,812
Other underwriting expenses	127,609,674	119,317,595
Total losses and underwriting expenses incurred	256,601,955	237,064,407
Net underwriting gain	21,345,494	28,233,295
Net investment income	28,221,741	32,249,833
Net realized capital losses, less tax benefit of \$3,597,036 and \$6,965,037 for 2009 and 2008, respectively	(6,680,209)	(12,935,070)
Total investment income	21,541,532	19,314,763
Other income	(417,744)	87,738
Income before federal income taxes, net of tax on realized losses	42,469,282	47,635,796
Federal income tax expense	13,521,562	20,921,262
Net income	28,947,720	26,714,534
Capital and surplus at beginning of year	678,041,169	752,004,325
Change in unrealized gains (losses) of investments (net of tax)	116,714,745	(31,890,770)
Change in net deferred income tax	(1,031,936)	773,149
Change in nonadmitted assets	1,534,550	374,731
Change in provision for reinsurance	(45,400)	65,200
Dividends to stockholder	(40,000,000)	(70,000,000)
Capital and surplus at end of year	\$ 784,160,848	678,041,169

See accompanying notes to statutory financial statements.

RLI INSURANCE COMPANY
Statutory Statements of Cash Flow
Years ended December 31, 2009 and 2008

	<u>2009</u>	<u>2008</u>
Operating activities:		
Premiums collected, net of reinsurance	\$ 277,895,447	268,474,341
Investment income, net of investment expense	30,301,591	35,923,529
Other income (expense)	(417,744)	87,738
Benefits and loss related payments	(80,125,160)	(69,686,990)
Commissions and other expenses paid	(155,209,445)	(156,787,572)
Federal income taxes paid	(6,620,014)	(12,362,072)
Net cash flow from operations	<u>65,824,675</u>	<u>65,648,974</u>
Investing activities:		
Cash provided from investments sold, matured, or repaid:		
Bonds	249,465,211	193,503,739
Stocks	81,716,272	50,549,222
Miscellaneous proceeds	16,925,208	163,268
Cost of investments acquired:		
Bonds	(330,378,015)	(118,915,131)
Stocks	(72,720,255)	(60,600,754)
Real estate	(86,794)	(3,184,190)
Miscellaneous cash applications	(45,424)	(15,214,278)
Net cash flow from investing activities	<u>(55,123,797)</u>	<u>46,301,876</u>
Financing activities and miscellaneous sources:		
Borrowed funds received (repaid)	—	(28,022,985)
Dividends to stockholder	(40,000,000)	(70,000,000)
Other cash provided	27,337,025	13,618,600
Net cash flow from financing activities and miscellaneous sources	<u>(12,662,975)</u>	<u>(84,404,385)</u>
Net change in cash and short-term investments	(1,962,097)	27,546,465
Cash and short-term investments at beginning of year	<u>56,690,060</u>	<u>29,143,595</u>
Cash and short-term investments at end of year	<u>\$ 54,727,963</u>	<u>56,690,060</u>

See accompanying notes to statutory financial statements.

RLI INSURANCE COMPANY
Notes to Statutory Financial Statements
December 31, 2009 and 2008

(1) Background and Significant Accounting Policies

(a) Organization

RLI Insurance Company (the Company or RLI) is a wholly owned subsidiary of RLI Corp. The Company is primarily engaged in writing selected property and casualty insurance, including commercial fire, homeowners, general and product liability, directors and officers, commercial and personal umbrella, marine, and commercial auto. The Company also writes small-to-large commercial and small contract surety coverages, as well as those for the energy (plugging and abandonment of oil wells), petrochemical, and refining industries. In addition, the Company offers fidelity and crime coverage for commercial insureds and select financial institutions.

(b) Basis of Presentation

The accompanying statutory financial statements have been prepared in conformity with accounting practices prescribed or permitted by the Illinois Department of Insurance (the Department). The National Association of Insurance Commissioners' *Accounting Practices and Procedures* (NAIC SAP) has been adopted as a component of prescribed or permitted practices by the Department. The Department has adopted all of the prescribed accounting practices as stated in the NAIC SAP and the Company has no permitted accounting practices. Statutory accounting practices differ in certain respects from U.S. generally accepted accounting principles (GAAP). The most significant differences include the following:

- (1) Acquisition costs related to premiums written are expensed as incurred, rather than deferred to the extent recoverable and charged to operations ratably over the period covered by the related insurance policies as prescribed by GAAP.
- (2) Investments in bonds are not classified as to the Company's intention to trade, hold to maturity, or make available for sale. Investments in bonds are generally carried at amortized cost rather than fair value. Accordingly, unrealized changes in fair value attributable to bonds are not reflected in the statutory statements of income and changes in capital and surplus.
- (3) Certain assets are designated as nonadmitted assets and are charged to surplus, as opposed to being carried at amounts recoverable for GAAP purposes.
- (4) The realizability of deferred tax assets under GAAP is evaluated utilizing a "more likely than not" standard. A valuation allowance is established for deferred tax assets deemed not realizable using this standard. Under statutory accounting principles, the realizability of deferred tax assets is determined utilizing an admissibility test outlined in Statement of Statutory Accounting Principles (SSAP) No. 10R, *Income Taxes – Revised, A Temporary Replacement of SSAP No. 10*, as adopted in 2009. Under this standard, gross deferred tax assets are reduced by a statutory valuation allowance if it is more likely than not that some portion or all of the gross deferred tax assets will not be realized. Thereafter, a net deferred tax asset, for the tax effect of temporary differences between financial reporting and the tax basis of assets and liabilities, is only reported as an admitted asset to the extent of the sum of federal income taxes paid in prior years that can be recovered through loss carrybacks from temporary differences that reverse during a time frame corresponding with IRS tax loss carryback

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provisions, not to exceed three years; gross deferred tax assets expected to be realized within three years, but limited to 15% of adjusted surplus; and the amount of gross deferred tax assets that can be offset against gross deferred tax liabilities. Additionally, changes in the balances of deferred tax assets and liabilities result in increases or decreases in tax expense under GAAP, whereas under statutory accounting principles, these changes directly impact surplus. For contingent tax liabilities, GAAP also uses a “more likely than not” threshold for recognition purposes whereas SSAP uses a “probable” threshold in accordance with SSAP No. 5, *Liabilities, Contingencies and Impairments of Assets*.

- (5) A liability is established, which is not required under GAAP, by a direct charge to unassigned surplus for unsecured reinsurance recoverables from unauthorized reinsurers and certain past due amounts from authorized reinsurers, rather than just providing for the estimated amounts deemed uncollectible.
- (6) The liability for unpaid losses and loss adjustment expenses (LAE) is reported net of reinsurance recoverables, and unearned premiums are reported net of prepaid reinsurance premiums, rather than presenting these amounts gross of the effects of reinsurance ceded for GAAP.
- (7) Wholly owned insurance subsidiaries are reflected at net statutory book value with changes reflected directly in capital and surplus, as opposed to consolidation of assets and liabilities and income on the financial statements for GAAP.
- (8) The statutory statement of cash flow differs in certain respects from the presentation required by GAAP, including the presentation of the changes in cash and short-term investments instead of cash and cash equivalents. Short-term investments include securities with original maturities of one year or less at the time of acquisition.
- (9) The statutory financial statements are prepared in a form using language and groupings substantially the same as the annual statements filed with the NAIC and state regulatory authorities, which differ from the presentation and disclosures of financial statements presented under GAAP.
- (10) Comprehensive income, which is required under GAAP, is not determined for statutory reporting purposes.

Under GAAP, for the years ended December 31, 2009 and 2008, the Company had net income of \$29,971,636 and \$30,036,968, respectively. The Company’s GAAP shareholder’s equity amounted to \$943,371,730 and \$820,933,544 at December 31, 2009 and 2008, respectively.

Significant statutory accounting policies are as follows:

(c) ***Investments***

Bonds are generally carried at amortized cost with the discount or premium on bonds amortized using the scientific method. Bonds with a NAIC designation of 3-6 are carried at the lower of amortized cost or fair value. Interest income consists of interest collected during the period, the

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change in the due and accrued interest between the beginning and end of the period as well as reductions for premium amortization and interest paid on bonds acquired and the addition of discount accrual. Short-term investments are valued at cost, which approximates fair value, and are considered cash equivalents in the statutory financial statements. Realized investment gains and losses are determined at the trade date on the basis of the specific-identification method. Real estate is valued at cost less accumulated depreciation, which is computed on a straight-line basis over the estimated useful lives of the properties.

Loan-backed securities are carried at either amortized cost or the lower of amortized cost or fair value dependent upon NAIC designations. All of the Company's loan-backed securities were purchased subsequent to January 1, 1994. Loan-backed securities are amortized using currently estimated cash flows, including new prepayment assumptions, under the retrospective methodology. For loan-backed and structured securities that have been other-than-temporarily impaired, the prospective adjustment method is used subsequent to loss recognition. Prepayment assumptions for single-class and multiclass mortgage-backed securities were obtained from external sources and through management estimates. The Company uses an external pricing service to determine the fair value of its loan-backed/asset-backed securities.

Unaffiliated common stocks are carried at values assigned by the NAIC, which approximate fair value. Stocks of affiliates in which the Company has an interest of 20% or more are carried based upon the affiliate's audited statutory surplus. Dividends on stocks are credited to income on the ex-dividend date. Realized investment gains and losses are determined at the trade date on the basis of the specific-identification method. Unrealized gains or losses are charged or credited directly to unassigned surplus, net of the provision for deferred income taxes.

Highest-quality or high-quality redeemable preferred stocks (NAIC designations 1 and 2) that have characteristics of debt securities are carried at cost or amortized cost. Highest-quality or high-quality perpetual preferred stocks (NAIC designations 1 and 2) that have characteristics of equity securities are carried using unit prices as reported in the NAIC *Valuations of Securities Manual*. Dividends on preferred stock, other than mandatorily redeemable preferred stock, are recorded as investment income on the ex-dividend date. Dividends on mandatorily redeemable preferred stock are accrued to the redemption price, even if not declared, using the interest method over the period ending on the redemption date. The Company did not have any preferred stock investments with NAIC ratings 3-6 as of December 31, 2008, nor did the Company hold any preferred stock investments as of December 31, 2009.

The Company reviews the values of their investments in bonds and common stocks on a quarterly basis for other-than-temporary impairment losses. Investments that have a fair value that is less than cost or amortized cost are evaluated for other-than-temporary impairment. The Company's methodology of assessing other-than-temporary impairments is based on security-specific facts and circumstances as of the date of the reporting period. Management considers the length of time and the extent to which the fair value has been less than cost, the financial condition and short-term prospects of the issuer including any specific events that may influence the operations of the issuer, and whether or not the Company intended to sell bonds with interest-related impairments in evaluating other-than-temporary impairment. Pursuant to the adoption of SSAP No. 43R, *Loan-Backed and Structured Securities*, effective July 1, 2009, loan-backed and structured securities, for

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which the Company does not have the intent to sell or for which it is not more likely than not that the Company will be required to sell prior to recovery of amortized cost and which are ultimately deemed to be other-than-temporarily impaired, are written down to net discounted cash flows with a corresponding realized loss recognized in the statements of income. For loan-backed and structured securities that may be other-than-temporarily impaired, the Company's historical practice has generally been to sell these securities to maximize the associated tax benefit. Given this intent to sell, other-than-temporary losses on such securities are recorded to fair value. If any other security is deemed to be other-than-temporarily impaired, it is written down to fair value with a corresponding realized loss recognized in the statements of income.

Prior to July 1, 2009, for loan-backed and structured securities, the Company recorded impairments to fair value under the provisions of the exposed and now superseded SSAP No. 98, *Treatment of Cash Flows When Quantifying Changes in Valuation and Impairments*.

(d) Investment in Affiliates and Related Parties

The Company owns 100% of the common stock of Mt. Hawley Insurance Company (Mt. Hawley), Safe Fleet Insurance Services, Inc. (Safe Fleet), RLI Insurance Ltd (RLI Ltd), Underwriters Indemnity General Agency (UIGA), and RLI Underwriting Services, Inc. (RLI US). Mt. Hawley is engaged in writing excess and surplus lines of insurance. The Company's investment in Mt. Hawley is carried at cost plus equity in statutory net income and surplus adjustments since the date of formation, less dividends received. Changes in the carrying value of the Company's investment in Mt. Hawley are reflected directly in unassigned surplus. Mt. Hawley maintains at December 31, 2009 an investment of 2,022,086 shares in its ultimate parent, RLI Corp. The estimated fair value of this common stock at December 31, 2009, after reduction of Mt. Hawley's reciprocal ownership, was \$26,038,618.

Safe Fleet, RLI Ltd, UIGA, and RLI US are valued based on their underlying audited GAAP equity adjusted to a statutory basis of accounting under the provisions of SSAP No. 97, *Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 88*. Per SSAP No. 97, the Company has nonadmitted its investment in Safe Fleet, RLI Ltd, UIGA, and RLI US since GAAP audits are not conducted individually for these subsidiaries.

(e) Revenue Recognition

Premiums, net of reinsurance, are earned and recognized as revenue ratably in relation to the risk covered over the period of the underlying policies. Unearned premiums, which are reflected net of reinsurance, represent the pro rata portion of premiums written, which are applicable to the unexpired terms of the policies in force.

(f) Acquisition Costs

The costs of acquiring insurance premiums (principally commissions and premium taxes) are charged to current operations as incurred.

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(g) *Liability for Unpaid Losses and Loss Adjustment Expenses*

The estimated liability for unpaid losses and loss adjustment expenses includes a provision for reported and unpaid losses as well as estimates of losses incurred but not reported, net of amounts covered by reinsurance. The estimates are based on certain actuarial and other assumptions related to the ultimate cost to settle such claims. Such assumptions are subject to occasional changes due to evolving economic, social, and political conditions. All estimates are periodically reviewed and, as experience develops and new information becomes known, the reserves are adjusted as necessary. Such adjustments are reflected in the results of operations in the period in which they are determined. As these amounts are determined based upon estimates, the ultimate liability may be more or less than such estimates. Based on the current assumptions used in estimating reserves, management believes that the Company's overall reserve levels at December 31, 2009 make a reasonable provision to meet its future obligations.

(h) *Federal Income Taxes*

The Company files a consolidated federal income tax return with RLI Corp. and affiliates. The provision for federal income taxes is based on current taxable income. The method of allocation between the companies is subject to written agreement and approved by the board of directors. Allocation is based on the ratio of that portion of the separate company taxable income each member bears to the total taxable income of the group. Intercompany tax balances are settled within 30 days of filing the consolidated income tax return.

Current year federal income tax expense is based on financial reporting income or loss adjusted for certain permanent and timing differences. The timing differences are the result of dissimilar financial reporting and tax basis accounting methods. A net deferred tax asset, net of any requisite valuation allowance, representing the tax effect of timing differences between financial reporting and the tax basis of assets and liabilities is only reported as an admitted asset to the extent that it will be realized subject to the provisions of SSAP 10R, which was adopted during 2009. The change in net deferred tax asset or liability is reflected directly in unassigned surplus.

The Company records liabilities for potential tax contingencies only when it is probable the position will not be sustainable upon audit by taxing authorities. These liabilities are reevaluated routinely and are adjusted appropriately based upon changes in facts or law. Penalties and interest, in the event they are incurred, are included in tax expense. The amount of uncertain tax items is not significant as of December 31, 2009 and 2008, respectively.

(i) *Provision for Reinsurance*

A statutory reinsurance liability must be established for unsecured amounts ceded to unauthorized reinsurers and certain amounts of past due recoverables from authorized reinsurers. This amount is recorded through a direct charge to unassigned surplus.

(j) *Nonadmitted Assets*

Certain assets (principally direct premiums 90 days past due, office furniture and equipment, EDP equipment, real estate, and certain investments in affiliates) are designated as nonadmitted assets and charged to unassigned surplus.

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(k) *Allowance for Uncollectible Reinsurance*

The Company continuously monitors the financial condition of its reinsurers. As part of the Company's monitoring efforts, the Company reviews the reinsurers' annual financial statements and, to the extent applicable, Securities and Exchange Commission filings. The Company also reviews insurance industry developments that may impact the financial condition of its reinsurers. The Company analyzes the credit risk associated with its reinsurance balances recoverable by monitoring the A.M. Best and Standard & Poor's (S&P) ratings of its reinsurers. In addition, the Company subjects its reinsurance recoverables to detailed recoverability tests, including one based on average default by S&P rating. Based upon the Company's review and testing, its policy is to charge to earnings, in the form of an allowance, an estimate of unrecoverable amounts from reinsurers. This allowance is reviewed on an ongoing basis to ensure that the amount makes a reasonable provision for reinsurance balances that the Company may be unable to recover.

(l) *Depreciation and Amortization*

Currently all depreciation and amortization is calculated using the straight-line method. The useful lives are as follows: 3 years for computers and external operating software and 5 to 40 years for tenant improvements and real estate. Depreciation and amortization expense for the Company totaled \$2,363,766 and \$2,611,528 for 2009 and 2008, respectively.

(m) *Risks and Uncertainties*

Certain risks and uncertainties are inherent to the Company's day-to-day operations and to the process of preparing its statutory financial statements. The more significant of those risks and uncertainties, as well as the Company's methods for attempting to mitigate, quantify, and minimize such risks and uncertainties, are presented below and throughout the notes to the statutory financial statements.

Catastrophe Exposures

The Company's insurance coverages include exposure to catastrophic events. The Company's major catastrophe exposure is to losses caused by earthquakes, primarily on the West Coast. Its second largest catastrophe exposure is to losses caused by hurricanes to commercial properties throughout the Gulf and East Coasts, as well as to homes the Company insures in Hawaii. The Company monitors these exposures by quantifying its exposed policy limits in each region and by using computer-assisted modeling techniques. Additionally, the Company further limits its risk to such catastrophes through the purchase of reinsurance.

Environmental Exposures

The Company is subject to environmental claims and exposures through its commercial umbrella, general liability, and discontinued assumed reinsurance lines of business. Although exposure to environmental claims exists in these lines of business, management has attempted to mitigate or control the extent of this exposure through the following methods: 1) the Company's policies include pollution exclusions that have been continually updated to further strengthen the exclusion and 2) the Company's policies primarily cover moderate hazard risks. The Company includes historical environmental loss experience with the remaining loss experience in the applicable line of business

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to project ultimate incurred losses and loss adjustment expenses and related incurred but not reported loss and LAE reserves.

Although historical experience on environmental claims may not accurately reflect future environmental exposures, the Company has used this experience to record loss and loss adjustment expense reserves in the exposed lines of business. See further discussion of environmental exposures in note 8.

Reinsurance

Reinsurance does not discharge the Company from its primary liability to policyholders, and to the extent that a reinsurer is unable to meet its obligations, the Company would be liable. The Company continuously monitors the financial condition of prospective and existing reinsurers. As a result, the Company currently purchases reinsurance from a number of financially strong reinsurers. The Company provides an allowance for reinsurance balances deemed uncollectible, as discussed previously.

Investments

The Company's investment portfolio is subject to market, credit, and interest rate risks. The equity portfolio will fluctuate with movements in the overall stock market. While the equity portfolio has been constructed to have lower downside risk than the market, the portfolio is sensitive to movements in the market. The bond portfolio is affected by interest rate changes and credit spreads. The Company attempts to mitigate its interest rate and credit risks by constructing a well-diversified portfolio with high-quality securities.

The prolonged downturn of the global financial markets and economy resulted in significant declines and lack of liquidity in the financial markets. While the Company maintains a high quality portfolio, it was not immune to the negative swings in the markets. The deterioration was not limited in its scope, as most segments of the financial markets were impacted. Continued downturns in the financial markets could have a negative effect on the Company's portfolio. However, the Company attempts to manage this risk through asset allocation and security selection.

Liquidity Risk

Liquidity is essential to the Company's business and a key component of its concept of asset-liability matching. The Company's liquidity may be impaired by an inability to collect premium receivable or reinsurance recoverable balances timely, an inability to sell assets or redeem its investments, an inability to access funds from its insurance subsidiaries, unforeseen outflows of cash or large claim payments, or an inability to access debt or equity capital markets. This situation may arise due to circumstances that the Company may be unable to control, such as a general market disruption or an operational problem that affects third parties or the Company, or even by the perception among market participants that the Company, or other market participants, is experiencing greater liquidity risk. To date, disruptions in the financial markets have not increased the Company's cost of funding and have not limited its access to some of its traditional sources of liquidity. The Company's credit ratings are important to its liquidity. A reduction in the Company's credit ratings could adversely

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affect its liquidity and competitive position, increase its borrowing costs, or limit its access to the capital markets.

Use of Estimates

The preparation of statutory financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosures of contingent assets and liabilities as of the date of the financial statements and the reported amounts of revenues and expenses for the reporting period. Actual results could differ from those estimates. The most significant of these amounts is the liability for unpaid losses and loss adjustment expenses. Management continually updates its estimates as additional data becomes available and adjusts the statutory financial statements as deemed necessary. Other estimates such as the recoverability of reinsurance balances are constantly monitored, evaluated, and adjusted. Although recorded estimates are supported by actuarial computations and other data, the estimates are ultimately based on management's expectations of future events. It is reasonably possible that expectations associated with these accounts can change in the near term (i.e., one year) and that the effect of these changes could be material to the statutory financial statements.

External Factors

The Company is regulated by the Illinois Department of Insurance, as well as states in which it does business. Such regulations, among other things, limit the amount of dividends, impose restrictions on the amount and types of investments, and regulate rates insurers may charge for various products. The Company is also subject to insolvency and guarantee fund assessments for policyholder losses covered by insolvent insurers. The Company generally accrues an assessment during the period in which it becomes probable that a liability has been incurred from an insolvency and the amount of the related assessment can be reasonably estimated.

The NAIC has developed Property-Casualty Risk-Based Capital (RBC) standards that relate an insurer's reported statutory capital and surplus to the risks inherent in its overall operations. The RBC formula uses the statutory annual statement to calculate the minimum indicated capital level to support asset (investment and credit) risk and underwriting (loss reserves, premiums written, and unearned premium) risk. If applicable, the NAIC calls for various levels of regulatory action based on the magnitude of an indicated RBC capital deficiency. The Company continuously monitors its internal capital requirements and the NAIC's RBC developments. The Company has determined that its capital levels are in excess of the minimum capital requirements for all RBC action levels. Management believes that the Company's capital levels are sufficient to support the level of risk inherent in its operations.

(n) Fair Value Disclosures

Equity securities, which include common stocks and preferred stocks, are valued using NAIC fair value prices, if available. If a NAIC fair value is not available, fair value is estimated using quoted market prices of the security or similar securities. Equity securities are carried at NAIC fair value, whereas bonds are generally carried at amortized cost based upon NAIC designations. Due to the relatively short-term nature of cash, short-term investments, accounts receivable, and accounts

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payable, the carrying value of each is a reasonable estimate of fair value. The Company's approach to determining the fair values of bonds and equities is disclosed in notes 2 and 3.

(o) Significant Events

During 2009 and 2008, the Company paid ordinary cash dividends to its parent, RLI Corp., of \$40,000,000 and \$70,000,000, respectively.

(p) Recent Accounting Pronouncements

During 2009, the NAIC adopted SSAP No. 43R, *Loan-Backed and Structured Securities*. SSAP No. 43R supersedes SSAP No. 98, *Treatment of Cash Flows When Quantifying Changes in Valuation and Impairments*, and paragraph 13 of SSAP No. 99, *Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment*. If the fair value of an asset-backed or structured debt security is less than its amortized cost basis at the reporting date, an entity shall assess whether the impairment is other-than-temporary. When an entity intends to sell an impaired loan-backed or structured security or more likely than not will be required to sell an impaired loan-backed or structured security before recovery of its amortized cost basis, an other-than-temporary impairment is recognized in earnings as the difference between the amortized cost basis and fair value. If an entity does not intend to sell the security and it is not more likely than not that it would be required to sell the security before recovery of its amortized cost basis and the security is deemed other-than-temporarily impaired, a credit loss is recorded in earnings based upon the discounted cash flows expected to be collected.

SSAP No. 43R also required a cumulative effect adjustment to the opening balance of unassigned surplus in the period of adoption for other-than-temporary-impairments on structured debt securities recognized in prior periods, which are still held as investments at July 1, 2009. The accounting guidance is effective for interim and annual reporting periods ending September 30, 2009. There was no cumulative effect adjustment necessary as of July 1, 2009 related to the Company's adoption of this standard, given the Company's intent to dispose of any other-than-temporarily impaired loan-backed or structured security.

In 2009, the Company adopted SSAP No. 99, *Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment*. This statement adopts the guidance in paragraph 16 of Financial Accounting Standards Board Staff Position FAS 115-1/124-1 with modification to be consistent with statutory language in the respective statutory accounting statements. Paragraph 16 describes the accounting for debt securities subsequent to other-than-temporary impairment. There was no impact to the financial statements upon adoption of this standard by the Company.

In 2009, the NAIC adopted temporary changes to SSAP No. 10, *Income Taxes*, and issued SSAP No. 10R, *Income Taxes – Revised, A Temporary Replacement of SSAP No. 10*. The changes are effective for the years ended December 31, 2010 and 2009, and for interim reporting periods in 2010. Under this new guidance, the Company considers a statutory valuation allowance against deferred tax assets that may or may not be realized. There are also new elective admissibility considerations, including the increase in the loss carryback allowance from one year to a limit not to exceed three years and a capital and surplus limitation increasing from 10% to 15%. The Company met certain RBC requirements and elected to pursue the additional admissibility considerations offered by the

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standard. However, there was no change in the admissibility of deferred tax assets as there were no non-admitted deferred tax assets as of December 31, 2009 or 2008.

(q) Prospective Accounting Pronouncements

During 2010, the NAIC adopted SSAP No. 100, *Fair Value Measurements* (SSAP No. 100). SSAP No. 100 provides guidance on defining fair value, establishing a framework for measurement of fair value, and expanding fair value disclosures. This new SSAP applies fair value when required by other statutory accounting pronouncements that require or permit fair value measurements, but does not require any new items to be measured at fair value. SSAP No. 100 establishes a fair value hierarchy to increase consistency and comparability in fair value measurements and related disclosures. SSAP No. 100 is effective for years ending December 31, 2010 and subsequent. The Company does not expect the adoption of this guidance to have a material impact on the Company's financial statements.

(2) Fair Value Measurement

Certain financial instruments are periodically measured at fair value on a nonrecurring basis, such as when impaired, or for certain bonds when carried at the lower of cost or fair value.

The fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties (exit price), that is other than in a forced or liquidation sale. The fair value of a liability is the amount at which that liability could be incurred or settled in a current transaction between willing parties, that is, other than a forced or liquidation sale.

Fair values are based on quoted market prices when available. In instances where there is little or no market activity for the same or similar instruments, the Company estimates fair value using observable information that management believes market participants would use to determine a current transaction price. This process involves some level of management estimation and judgment, which becomes significant with increasingly complex instruments.

The Company's financial assets and liabilities carried at fair value have been classified, for disclosure purposes, based on a hierarchy which gives the highest ranking to fair values determined using unadjusted quoted prices in active markets for identical assets and liabilities (Level 1) and the lowest ranking to fair values determined using methodologies and models with unobservable inputs (Level 3). An asset's or liability's classification is based on the lowest level input that is significant to its measurement. For example, a Level 3 fair value measurement may include inputs that are both observable (Levels 1 and 2) and unobservable (Level 3). The levels of the fair value hierarchy are as follows:

Level 1 – Quoted price (unadjusted) in active markets for identical assets.

Level 2 – Inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the instrument.

Level 3 – Inputs to the valuation methodology are unobservable for the asset or liability.

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Financial assets and liabilities measured at fair value on a recurring basis

Certain financial assets are measured at fair value on a recurring basis, such as unaffiliated common stock, which is carried at values assigned by the NAIC that approximate fair value. The following table summarizes assets measured at fair value on a recurring basis as of December 31, 2009 and 2008, respectively:

Description	Fair value at December 31		
	Level 1	Level 2	Level 3
2009:			
Equities	\$ 176,733,568	—	—
2008:			
Equities	165,667,930	—	—

Assets measured at fair value on a nonrecurring basis

Certain financial assets are measured at fair value on a nonrecurring basis. Generally, bonds are carried at amortized cost. Bonds with a NAIC designation of 3-6, however, are carried at the lower of amortized cost or fair value. In addition, investments that are other-than-temporarily impaired during the reporting period are recorded at fair value on the statutory financial statements. The following table summarizes bonds measured at fair value on a nonrecurring basis as of December 31, 2009 and 2008, respectively:

Description	Fair value at December 31		
	Level 1	Level 2	Level 3
2009:	\$ —	1,967,500	—
Corporate and other securities			
2008:	—	5,046,536	—
Corporate and other securities			

(3) Investments

The Company's bond portfolio consists of investments in U.S. treasury, government-sponsored agency, corporate, municipal, mortgage-backed, and asset-backed securities. All bonds in the investment portfolio continue to pay the expected coupon payments under the contractual terms of the securities and the Company believes it is probable that it will receive all contractual or estimated cash flows based on its analysis of previously disclosed factors.

The statement value and estimated fair value of bonds at December 31, 2009 and 2008, respectively, are reflected below. The fair values for bonds are based on quoted market prices, where available. For bonds not actively traded, fair values are estimated using values obtained from independent pricing services.

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2009				
	Statement value	Gross unrealized gains	Gross unrealized losses	Estimated fair value
United States Treasury securities	\$ 158,016	—	(10,716)	147,300
Government agencies				
and government-backed securities	142,630,443	1,016,045	(1,697,206)	141,949,282
States, political subdivisions, and				
special revenue securities	126,643,450	4,204,814	(227,710)	130,620,554
Corporate and other securities	181,244,538	7,331,512	(668,077)	187,907,973
Mortgage-backed securities and				
collateralized mortgage				
obligations (CMOs)	105,095,574	3,432,669	(134,176)	108,394,067
Totals	\$ 555,772,021	15,985,040	(2,737,885)	569,019,176
2008				
	Statement value	Gross unrealized gains	Gross unrealized losses	Estimated fair value
United States Treasury securities	\$ 4,059,982	231,703	—	4,291,685
Government agencies				
and government-backed securities	86,229,456	1,765,179	(11,978)	87,982,657
States, political subdivisions, and				
special revenue securities	154,174,575	3,821,184	(1,132,321)	156,863,438
Corporate and other securities	128,117,147	1,077,808	(8,277,395)	120,917,560
Mortgage-backed securities and				
collateralized mortgage				
obligations (CMOs)	100,836,971	2,001,534	(2,799,854)	100,038,651
Totals	\$ 473,418,131	8,897,408	(12,221,548)	470,093,991

The unrealized losses in the government agencies portfolio were caused by a general rise in Treasury bond yields during 2009. The rise in yields was caused as investors left the relative safety of U.S. Treasuries as the credit crisis abated. The government agency portfolio has an overall rating of AAA and the Company believes it is probable that it will receive all contractual payments in the form of principal and interest. In addition, the Company does not intend to sell these investments and would expect to hold these investments until a recovery in value, which may be until maturity. The Company does not consider these investments to be other-than-temporarily impaired at December 31, 2009 and 2008.

The unrealized losses in the Company's mortgage-backed and collateralized mortgage obligations (CMOs) portfolio have dramatically decreased year over year as the credit crisis has subsided and housing markets have stabilized. The securities remain AAA rated by one or more rating agency and the Company believes it is probable that it will receive all contractual or estimated cash flows in the form of principal and interest. The Company does not intend to sell these securities and would expect to hold these investments

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until recovery in value, which may be maturity, and thus does not consider these investments to be other-than-temporarily impaired at December 31, 2009.

The following tables illustrate the total value of securities, other than affiliated Company investments, that were in an unrealized loss position as of December 31, 2009 and 2008, respectively:

		2009	
	Less than 12 months	12 months or Greater	Total
		(In thousands)	
U.S. government:			
Fair value	\$ 147	—	147
Cost or amortized cost	158	—	158
Unrealized loss	\$ (11)	—	(11)
U.S. agency:			
Fair value	\$ 95,242	—	95,242
Cost or amortized cost	96,939	—	96,939
Unrealized loss	\$ (1,697)	—	(1,697)
Mortgage-backed:			
Fair value	\$ 1,948	—	1,948
Cost or amortized cost	1,984	—	1,984
Unrealized loss	\$ (36)	—	(36)
ABS/CMO*			
Fair value	\$ 2,624	1,628	4,252
Cost or amortized cost	2,685	1,665	4,350
Unrealized loss	\$ (61)	(37)	(98)
Corporate:			
Fair value	\$ 28,752	3,740	32,492
Cost or amortized cost	29,163	3,997	33,160
Unrealized loss	\$ (411)	(257)	(668)
States, political subdivisions, and revenues:			
Fair value	\$ 28,419	—	28,419
Cost or amortized cost	28,647	—	28,647
Unrealized loss	\$ (228)	—	(228)
Subtotal, debt securities:			
Fair value	\$ 157,132	5,368	162,500
Cost or amortized cost	159,576	5,662	165,238
Unrealized loss	\$ (2,444)	(294)	(2,738)
Common stock:			
Fair value	\$ 11,801	2,467	14,268
Cost or amortized cost	12,085	2,623	14,708
Unrealized loss	\$ (284)	(156)	(440)
Total temporarily impaired securities:			
Fair value	\$ 168,933	7,835	176,768
Cost or amortized cost	171,661	8,285	179,946
Unrealized loss	\$ (2,728)	(450)	(3,178)

* Asset-backed & collateralized mortgage obligations

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	2008		
	Less than 12 months	12 months or Greater	Total
	(In thousands)		
U.S. agency:			
Fair value	\$ 888	—	888
Cost or amortized cost	900	—	900
Unrealized loss	<u>\$ (12)</u>	<u>—</u>	<u>(12)</u>
Mortgage-backed:			
Fair value	\$ 34	—	34
Cost or amortized cost	34	—	34
Unrealized loss	<u>\$ —</u>	<u>—</u>	<u>—</u>
ABS/CMO*			
Fair value	\$ 4,931	14,369	19,300
Cost or amortized cost	5,586	16,514	22,100
Unrealized loss	<u>\$ (655)</u>	<u>(2,145)</u>	<u>(2,800)</u>
Corporate:			
Fair value	\$ 63,512	11,701	75,213
Cost or amortized cost	68,916	14,574	83,490
Unrealized loss	<u>\$ (5,404)</u>	<u>(2,873)</u>	<u>(8,277)</u>
States, political subdivisions, and revenues:			
Fair value	\$ 33,280	4,973	38,253
Cost or amortized cost	34,088	5,298	39,386
Unrealized loss	<u>\$ (808)</u>	<u>(325)</u>	<u>(1,133)</u>
Subtotal, debt securities:			
Fair value	\$ 102,645	31,043	133,688
Cost or amortized cost	109,524	36,386	145,910
Unrealized loss	<u>\$ (6,879)</u>	<u>(5,343)</u>	<u>(12,222)</u>
Common stock:			
Fair value	\$ 48,209	12,386	60,595
Cost or amortized cost	61,801	16,560	78,361
Unrealized loss	<u>\$ (13,592)</u>	<u>(4,174)</u>	<u>(17,766)</u>
Total temporarily impaired securities:			
Fair value	\$ 150,854	43,429	194,283
Cost or amortized cost	171,325	52,946	224,271
Unrealized loss	<u>\$ (20,471)</u>	<u>(9,517)</u>	<u>(29,988)</u>

* Asset-backed & collateralized mortgage obligations

The Company's stock portfolio consists of common stock and exchange-traded funds (ETFs). The majority of net unrealized losses at December 31, 2009 are due to one healthcare and one automotive services stock. None of the equity securities are in an unrealized loss position of more than 8%. The Company has the ability and intent to hold these securities until recovery and therefore does not consider any equity securities to be other-than-temporarily impaired at December 31, 2009.

As of December 31, 2009, the Company held 8 common stocks that were in unrealized loss positions totaling \$0.4 million. As of December 31, 2008, the Company held 31 common and preferred stocks that were in unrealized loss positions totaling \$17.8 million. None of these securities have been in a loss position of at least 20% for any period of time. Only one security has been in an unrealized loss position

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for twelve or more consecutive months. However, this security only had an unrealized loss of 5.9% relative to book value. We believe these securities have the ability to substantively recover in a reasonable time period. Therefore, no equity securities held as of December 31, 2009 are considered other than temporarily impaired. As of December 31, 2009 and 2008, 76 and 160 bonds, respectively, had an unrealized loss. These bonds represent a total fair value of \$162.5 million and \$133.7 million, respectively, and a total unrealized loss of \$2.7 million and \$12.2 million, respectively, as of December 31, 2009 and 2008. None of these bonds were in an unrealized loss position of more than 20% for more than six consecutive months. In addition, of the 76 bonds that were in an unrealized loss position as of December 31, 2009, 72 have been in an unrealized loss position for less than 12 months. The fixed income unrealized losses can primarily be attributed to spreads widening in the corporate, municipal, and mortgage-backed security markets. The Company does not intend to sell these securities, and would expect to hold them to maturity. In addition, the Company continually monitors the credit quality of its fixed income investments to assess if it is probable that it will receive its contractual or estimated cash flows in the form of principal and interest. The Company considers price declines of securities in its other-than-temporary impairment analysis where such price declines provide evidence of declining credit quality, and distinguishes between price changes caused by credit deterioration, as opposed to rising interest rates.

Key factors that are considered in the evaluation of credit quality include:

- Changes in technology that may impair the earnings potential of the investment,
- The discontinuance of a segment of the business that may affect the future earnings potential,
- Reduction or elimination of dividends,
- Specific concerns related to the issuer's industry or geographic area of operation,
- Significant or recurring operating losses, poor cash flows, and/or deteriorating liquidity ratios, and
- Downgrade in credit quality by a major rating agency.

The Company concluded that the securities in an unrealized loss position are not other-than-temporarily impaired.

During 2009 and 2008, the Company recognized impairment losses of \$26.7 million and \$34.1 million, respectively. This total includes \$25.0 million and \$28.4 million related to equity securities and \$1.7 million and \$5.7 million, respectively, related to fixed income securities. The majority of the Company's other-than-temporary impairment for 2009 was recorded in the first quarter and is related to Exchange Traded Funds (ETFs) that track the overall equity markets. The impaired securities were negatively impacted by the overall financial crisis as the equity markets hit lows not seen in over a decade. There was one loan-backed and structured security that was deemed other-than-temporarily impaired during 2009, and given the Company's intent to sell, the impairment loss was recorded to fair value.

The statement value and estimated fair value of bonds at December 31, 2009 by contractual maturity are shown below. Actual maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties and because most mortgage-backed and asset-backed securities provide for periodic payments throughout their lives. Such securities have been classified in the following table based upon contractual maturities.

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	<u>Statement value</u>	<u>Estimated fair value</u>
Due in one year or less	\$ 12,643,023	12,840,257
Due after one year through five years	102,330,812	107,642,320
Due after five years through ten years	218,443,321	223,029,034
Due after ten years	117,259,291	117,113,498
Mtge/ABS/CMO*	105,095,574	108,394,067
	<u>\$ 555,772,021</u>	<u>569,019,176</u>

* Mortgage-backed, asset-backed, & collateralized mortgage obligations.

Proceeds from sales of bonds during 2009 and 2008 were \$99,174,034 and \$76,853,137, respectively. Proceeds from maturities/calls of bonds during 2009 and 2008 were \$150,291,177 and \$116,650,602, respectively. Proceeds from sales of equity securities during 2009 and 2008 were \$81,716,272 and \$50,549,222, respectively.

The components of realized gains and losses on investments are as follows:

	<u>2009</u>	<u>2008</u>
Bonds:		
Gains	\$ 4,815,708	2,263,329
Losses	(370,784)	(1,025,423)
OTTI	(1,710,729)	(5,689,658)
Realized gains (losses) on bonds	<u>2,734,195</u>	<u>(4,451,752)</u>
Stocks:		
Gains	12,088,681	13,104,587
Losses	(107,844)	(157,847)
OTTI	(24,992,277)	(28,395,095)
Realized losses on stocks	<u>(13,011,440)</u>	<u>(15,448,355)</u>
Less:		
Income tax benefit	<u>(3,597,036)</u>	<u>(6,965,037)</u>
	<u>(3,597,036)</u>	<u>(6,965,037)</u>
Net realized losses on investments	<u>\$ (6,680,209)</u>	<u>(12,935,070)</u>

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The cost of common and preferred stocks of nonaffiliates owned at December 31, 2009 and 2008 was \$117,738,306 and \$139,703,128, respectively. Gross unrealized gains and losses on such investments are as follows:

	<u>2009</u>	<u>2008</u>
Unrealized gains	\$ 59,435,058	44,543,232
Unrealized losses	<u>(439,796)</u>	<u>(17,765,630)</u>
Net unrealized gains	<u>\$ 58,995,262</u>	<u>26,777,602</u>

The unrealized gains on investments in affiliates are as follows:

	<u>2009</u>	<u>2008</u>
Carrying value of investments in affiliates, gross of nonadmitted assets	\$ 568,001,446	472,747,764
Cost of investments in affiliates	<u>145,688,624</u>	<u>145,688,624</u>
Unrealized gains	<u>\$ 422,312,822</u>	<u>327,059,140</u>

The carrying value of investments in affiliates for 2009 and 2008 as reported in the statutory statements of admitted assets, liabilities, and capital and surplus is net of \$2,446,404 and \$2,638,336, respectively, of nonadmitted assets.

In 2009, the Company eliminated its exposure to subprime mortgages. The Company does not own any subprime mortgages, credit card asset-backed securities, or auto loan asset-backed securities as of December 31, 2009.

From an insurance standpoint, the casualty segment has exposure to subprime market issues through the Company's other liability (directors and officers) coverage. The Company's exposure to subprime, however, is minimal. The Company has a limited number of claims and expects future net exposure to subprime to be less than \$5.0 million. The surety segment is another area that the Company can have direct exposure to subprime. The Company writes few mortgage broker bonds, and believes this exposure to be minimal. In addition, the Company does not have significant exposure from a surety standpoint to the home building industry.

The Company completely exited its securities lending program as of June 30, 2009. At December 31, 2008, fixed maturities with a fair value of \$10.4 million were loaned.

Investments with a statement value of \$4,510,766 and \$4,809,789, as of December 31, 2009 and 2008, respectively, were on deposit with governmental authorities or banks to comply with insurance laws or were pledged as collateral for borrowing arrangements.

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The composition of net investment income is as follows:

	<u>2009</u>	<u>2008</u>
Bonds	\$ 23,979,343	26,495,479
Stocks	5,135,537	7,572,849
Real estate	1,372,559	1,124,760
Cash on deposit and short-term investments	274,921	651,163
Other	59,953	81,450
	<u>30,822,313</u>	<u>35,925,701</u>
Less investment expenses	<u>2,600,572</u>	<u>3,675,868</u>
Net investment income	<u>\$ 28,221,741</u>	<u>32,249,833</u>

(4) Related-Party Transactions

As described below and elsewhere in the notes to the statutory financial statements, the Company has engaged in transactions with its parent, affiliates, and subsidiaries during the normal course of business:

- (a) The Company allocates certain expenses to RLI Corp. and affiliated companies, Mt. Hawley, RLI Indemnity Company (RIC), RLI US, and Safe Fleet. The intercompany services agreement allows a portion of the expenses incurred by the Company for the benefit of these affiliates to be allocated on a pro rata basis relative to the affiliate companies' gross earned premium to the total of gross earned premiums of the Company, and any other affiliate managed by the Company. This agreement further allows the expenses incurred by Safe Fleet for the benefit of the Company to be charged back to the Company on a cost reimbursement basis. The Company allocated net expenses of \$38.4 million and \$35.8 million to the aforementioned related parties during 2009 and 2008, respectively, as a result of services performed.
- (b) The Company received no cash dividends from its wholly owned subsidiary, Mt. Hawley, in 2009 and 2008.
- (c) During 2009 and 2008, the Company paid RLI Corp. ordinary dividends of \$40.0 million and \$70 million.
- (d) At December 31, 2009 and 2008, the Company owns 100% of the common stock of its subsidiaries, Mt. Hawley, Safe Fleet, RLI Ltd, UIGA, and RLI US, having statement values of \$565,555,039, \$(205,587), \$1,047,542, \$998,869, and \$605,583, respectively. The Company nonadmitted its investment in Safe Fleet, UIGA, RLI Ltd, and RLI US, since GAAP audits are not conducted individually for these subsidiaries.
- (e) Based on the Company's 100% ownership of Mt. Hawley, the statement value of Mt. Hawley's assets and liabilities as of December 31, 2009 were \$1,097.6 million and \$532.1 million, respectively. Net income of Mt. Hawley was \$86.2 million for the year ended December 31, 2009. The statement value of Mt. Hawley's assets and liabilities as of December 31, 2008 were

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\$1,052.3 million and \$582.2 million, respectively. Net income of Mt. Hawley was \$46.2 million for the year ended December 31, 2008.

- (f) At December 31, 2009 and 2008, the Company reported \$5,763,640 as net amounts due to affiliates and \$4,863,045 as net amounts due from affiliates, respectively. Any intercompany balance resulting from services performed or costs allocated in accordance with the terms of the intercompany services agreement are settled within 30 calendar days following the end of the calendar quarter in which the intercompany balance was created.
- (g) On or about April 1, 2004, the Company entered into an intercompany guarantee with RLI Ltd. The Company has guaranteed the performance of RLI Ltd. with respect to a punitive damages wrap policy over an excess policy with the Company. The policy was not renewed during 2009.

(5) Borrowed Funds

The Company had no outstanding liability for borrowed money at December 31, 2009 and 2008. Interest paid on outstanding debt for 2009 and 2008 totaled \$0 and \$705,602, respectively.

(6) Capital and Surplus

Dividend payments from the Company to its parent are restricted by state insurance laws as to the amount that may be paid without prior approval from the regulatory authorities of Illinois. The maximum dividend distribution in a rolling 12-month period is limited by Illinois laws to the greater of 10% of policyholder surplus as of December 31 of the preceding year or net income of the Company for the 12-month period ending December 31 of the preceding year. Therefore, the maximum dividend that can be paid by the Company in a rolling 12-month period ending in 2009 without prior approval is \$78,416,085, which represents 10% of the Company's 2009 policyholder surplus.

State insurance laws also restrict dividend payments to the Company from Mt. Hawley. The maximum dividends that can be paid to the Company by Mt. Hawley for a 12-month rolling period during 2009 without prior approval are \$86.2 million, which represents Mt. Hawley's 2009 net income.

Unassigned surplus includes \$38,874,066 in net unrealized gains on unaffiliated investments. Unassigned surplus has been reduced by \$12,079,225 and \$13,613,775 relating to nonadmitted assets as of December 31, 2009 and 2008, respectively. Additionally, surplus has been reduced by \$883,400 and \$838,000 for the provision for reinsurance as of December 31, 2009 and 2008, respectively.

(7) Reinsurance

In the normal course of business, the Company assumes and cedes property and liability insurance exposures with other insurance companies, pools, and associations through various treaties and in certain instances by negotiation of individual risks. Generally, policies are reinsured with other insurance companies to limit the Company's risk on any individual loss to \$7,500,000.

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The following are summaries of the impact of the Company's reinsurance program on the statutory financial statements:

	2009			
	Direct	Assumed	Ceded	Net
Premiums written	\$ 355,288,706	18,145,491	90,563,917	282,870,280
Premiums earned	348,386,897	16,073,192	86,512,640	277,947,449
Losses and loss adjustment expenses incurred	143,078,968	10,997,045	25,083,732	128,992,281
Unearned premiums	187,836,340	8,117,231	42,864,979	153,088,592
Unpaid losses and loss adjustment expenses	537,969,105	54,178,977	219,032,255	373,115,827

	2008			
	Direct	Assumed	Ceded	Net
Premiums written	\$ 342,964,649	11,943,993	80,494,393	274,414,249
Premiums earned	332,784,176	9,530,947	77,017,421	265,297,702
Losses and loss adjustment expenses incurred	130,992,311	10,559,178	23,804,677	117,746,812
Unearned premiums	180,934,531	6,044,947	38,813,717	148,165,761
Unpaid losses and loss adjustment expenses	535,521,769	47,194,518	232,410,499	350,305,788

At December 31, 2009, net balances recoverable from reinsurers (comprising unearned premiums and losses and loss adjustment expenses paid and unpaid, including incurred but not reported amounts) having unsecured portions exceeding 3% of the Company's total capital and surplus were as follows:

Name of reinsurer	Amount
Axis Reinsurance Corp	\$ 23,804,000
Munich Re America	29,403,000

The losses, loss adjustment expenses, and unearned premiums for business ceded to other insurers are recoverable and realizable to the extent that the assuming reinsurers fulfill their commitments. The Company has initiated arbitration or otherwise instituted legal actions where appropriate on certain outstanding recoverable balances.

As of January 1, 2009 and 2008, the Company's property underwriting was supported by \$350 million and \$375 million, respectively, in traditional catastrophe reinsurance protection, subject to certain retentions by the Company. At January 1, 2010, the Company renewed its traditional catastrophe reinsurance protection at \$350 million, subject to certain retentions by the Company. The Company recorded a charge to income in 2009 and 2008 of \$1,021,602 and \$1,758,798, respectively, for reinsurance balances deemed uncollectible. This charge is reflected in losses and loss adjustment expenses incurred. The most significant component was a write-off of \$473,711 for balances due from Cherokee Insurance Company.

The total return commission, which would have been due reinsurers if all reinsurance was canceled with the return of unearned premium would be \$9,616,630 and \$8,572,511 as of December 31, 2009 and 2008,

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respectively. The amount of return commission, predicated on loss experience as a result of existing contracts, was \$0 and \$2,213 as of December 31, 2009 and 2008, respectively.

The Company participates in a quota share reinsurance agreement with RIC. The agreement is applied after all other external reinsurance sessions. Under the terms of the agreement, RIC cedes and RLI assumes 90% of the net premium and liabilities for policies effective January 1, 2003, and subsequent. The agreement, which was effective January 1, 2003, has been accepted and placed on file by the Department. This agreement was amended in 2004 to include the assumption of 100% of RIC's existing net loss reserves and any future development on these reserves. The Department approved the loss portfolio transfer on June 29, 2004.

The following is a summary of the balances assumed under this agreement as of and for the years ended December 31, 2009 and 2008 (in thousands):

	<u>2009</u>	<u>2008</u>
Premium written	\$ 1,832	4,001
Unearned premiums	1,669	1,621
Premium earned	1,784	4,313
Loss and loss adjustment expenses incurred	172	1,766
Reserve for loss and loss adjustment expenses	1,947	2,883

(8) Unpaid Losses and Loss Adjustment Expenses

The following table is a reconciliation of the Company's liability for unpaid losses and LAE for the years ended December 31, 2009 and 2008. Since reserves are based on estimates, the ultimate net cost may vary from the original estimate. As adjustments to these estimates become necessary, they are reflected in current operations. As part of the reserving process, historical data is reviewed and consideration is given to the anticipated impact of various factors such as legal developments and economic conditions, including the effects of inflation. Changes in reserves from the prior years' estimates are calculated based on experience as of the end of each succeeding year (loss and loss adjustment expense development).

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	<u>2009</u>	<u>2008</u>
	(In thousands)	
Net unpaid losses and loss adjustment expenses at beginning of year, net of reinsurance recoverable of \$232,411 and \$244,093 as of January 1	\$ 350,306	341,097
Incurred losses and loss adjustment expenses related to:		
Current accident year losses	148,634	134,097
Prior accident years losses	(19,642)	(16,350)
Total incurred	128,992	117,747
Paid loss and loss adjustment expense payments related to:		
Current accident year losses	(27,388)	(25,923)
Prior accident years losses	(78,794)	(82,615)
Total paid	(106,182)	(108,538)
Net unpaid losses and loss adjustment expenses at end of year, net of reinsurance recoverable of \$219,032 and \$232,411 as of December 31	\$ 373,116	350,306

Reserve Development

The deviations from the Company's initial reserve estimates appeared as changes in its ultimate loss estimates occurred as it updated those estimates through its reserve analysis process. The recognition of the changes in initial reserve estimates occurred over time as claims were reported, initial case reserves were established, initial reserves were reviewed in light of additional information, and ultimate payments were made on the collective set of claims incurred as of that evaluation date. The new information on the ultimate settlement value of claims is therefore continually updated and revised as this process takes place until all claims in a defined set of claims are settled. As a relatively small insurer, the Company's experience will ordinarily exhibit fluctuations from period to period. While the Company attempts to identify and react to systematic changes in the loss environment, it also must consider the volume of experience directly available, and interpret any particular period's indications with a realistic technical understanding of the reliability of those observations.

A discussion of significant components of reserve development for the two most recent calendar years follows:

2009: The majority of the \$19.6 million of favorable development in 2009 came from accident years 2006 and 2004 with sizable contributions also coming from accident years 2005 and 2008. By line of business, the most significant favorable development came from our Other Liability, Commercial Auto Liability and Surety lines. In addition to reported losses on prior accident years being generally less than expected, downward adjustments to the expected loss ratios that are used in calculating actuarial reserve estimates also contributed to the favorable development. Partially offsetting the results on these lines, we experienced unfavorable development on our Ocean Marine line driven primarily by the commercial towing exposure, as well as unfavorable development on accident years 2000 and prior due mostly to environmental exposures from runoff casualty business.

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2008: During 2008, the Company experienced favorable development overall on prior accident years' reserves totaling \$16.4 million. Other liability, property lines, and surety were the primary contributors to the favorable development, totaling \$8.5 million, \$6.5 million, and \$5.8 million, respectively. Favorable reserve development was partially offset by adverse development on assumed reinsurance and marine, which amounted to \$3.4 million and \$3.0 million, respectively. The five most recent accident years contributed the most to the favorable development. In retrospect, the expected loss ratios initially used to set booked reserves for these accident years have proven to be conservative, which has resulted in loss emergence significantly lower than expected.

The favorable development on other liability lines comes primarily from personal umbrella and directors and officers liability coverages. Favorable development on property is primarily due to builder's risk construction coverages. This line of business has been in run-off for three years and recent experience has been much better than expected, with a significant reduction in both frequency and severity of claims. Only a handful of contracts remain open and the Company has observed little new activity from this product line. The favorable development on surety is primarily from contract and commercial coverages from the 2007 accident year. Very little observed loss severity in the commercial surety coverage resulted in favorable emergence. In addition, continued improvement in the Company's contract surety loss ratio resulting from past re-underwriting of the business led to favorable loss reserve development. The adverse development from assumed reinsurance business comes from accident years prior to 1990 and was caused mostly by increases in reported losses on asbestos and environmental claims. Marine protection and indemnity coverage is the cause of the adverse marine development. For this coverage, loss ratio estimates and expected development patterns appear, so far, to have not been adequate.

Environmental Exposure

The Company has exposure to asbestos and environmental claims through its commercial umbrella, general liability, and discontinued assumed reinsurance lines of business. The majority of the exposure is in the excess layers of the Company's commercial umbrella and assumed reinsurance books of business.

Although a large majority of the Company's asbestos and environmental exposure is limited to losses occurring before the mid-1980s, management cannot determine the Company's ultimate liability with any high degree of certainty. The Company estimates the full impact of these exposures by establishing case basis reserves on all known losses. Reserves for related IBNR are recorded based upon actuarial projections of ultimate expected losses.

This ultimate liability is difficult to assess due to slow reporting of losses and evolving legislation on such issues as joint and several liability, retroactive liability, and standards of cleanup. Additionally, the Company participates primarily in the excess layers, making it difficult to assess the ultimate impact.

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The Company's asbestos-related loss and LAE reserves and incurred losses and LAE (including coverage dispute costs) for the years ended December 31, 2009 and 2008 were as follows:

	<u>2009</u>	<u>2008</u>
Direct:		
Beginning reserves	\$ 13,829,024	12,199,814
Incurred losses and LAE	(1,807,245)	1,657,269
Calendar year payments for losses and LAE	(12,057)	(28,059)
Ending reserves	<u>\$ 12,009,722</u>	<u>13,829,024</u>
Assumed:		
Beginning reserves	\$ 18,737,058	20,189,148
Incurred losses and LAE	1,699,931	2,141,153
Calendar year payments for losses and LAE	(1,305,940)	(3,593,243)
Ending reserves	<u>\$ 19,131,049</u>	<u>18,737,058</u>
Ceded:		
Beginning reserves	\$ 9,404,450	10,654,623
Incurred losses and LAE	2,194,696	(292,764)
Calendar year payments for losses and LAE	(1,232,860)	(957,409)
Ending reserves	<u>\$ 10,366,286</u>	<u>9,404,450</u>
Net:		
Beginning reserves	\$ 23,161,632	21,734,339
Incurred losses and LAE	(2,302,010)	4,091,186
Calendar year payments for losses and LAE	(85,137)	(2,663,893)
Ending reserves	<u>\$ 20,774,485</u>	<u>23,161,632</u>

The Company holds both IBNR and case loss reserves related to asbestos exposure. For asbestos, direct and assumed case incurred losses combined changed very little, but net case incurred losses decreased by about \$2.3 million. This decrease is primarily due to an increase in ceded IBNR resulting from our IBNR allocation process. Of the total reserves, the Company held IBNR reserves in the amount of \$15,486,110 and \$15,472,325 on a gross basis and \$8,641,770 and \$10,946,865 on a net basis at December 31, 2009 and 2008, respectively.

The Company held \$1,720,679 on a gross basis and \$960,197 on a net basis for future allocated loss adjustment expenses related to asbestos exposure (including coverage dispute costs) at December 31, 2009. The Company held \$1,771,365 on a gross basis and \$1,216,319 on a net basis for future allocated loss adjustment expenses related to asbestos exposure (including coverage dispute costs) at December 31, 2008.

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The Company's environmental-related loss and LAE reserves and incurred losses and LAE (including coverage dispute costs) for the years ended December 31, 2009 and 2008 were as follows:

	<u>2009</u>	<u>2008</u>
Direct:		
Beginning reserves	\$ 7,950,462	5,700,426
Incurred losses and LAE	2,463,009	2,583,285
Calendar year payments for losses and LAE	(490,898)	(333,249)
Ending reserves	<u>\$ 9,922,573</u>	<u>7,950,462</u>
Assumed:		
Beginning reserves	\$ 1,627,888	1,340,099
Incurred losses and LAE	202,223	331,174
Calendar year payments for losses and LAE	(50,896)	(43,385)
Ending reserves	<u>\$ 1,779,215</u>	<u>1,627,888</u>
Ceded:		
Beginning reserves	\$ 4,490,077	3,041,930
Incurred losses and LAE	1,752,218	1,690,618
Calendar year payments for losses and LAE	(110,052)	(242,471)
Ending reserves	<u>\$ 6,132,243</u>	<u>4,490,077</u>
Net:		
Beginning reserves	\$ 5,088,273	3,998,595
Incurred losses and LAE	913,014	1,223,841
Calendar year payments for losses and LAE	(431,742)	(134,163)
Ending reserves	<u>\$ 5,569,545</u>	<u>5,088,273</u>

The Company holds both IBNR and case loss reserves related to environmental exposure. Pollution emergence is driven by two separate developments in our direct book of business. The first is activity on a pollution claim from our Marine division. Case incurred losses for this claim in 2009 increased by about \$1.7 million direct and \$0.4 million net including payments of \$0.3 million. Additional development was driven by claim activity from the 1980s associated with a company RLI purchased in 1999. Case incurred pollution losses for this book increased by \$0.3 million direct and \$0.4 million net. While none of the claims are large, we have assigned more IBNR to this book of business as a whole, resulting in an increase of incurred losses of about \$1.0 million direct and \$0.8 million net. Of the total reserves, the Company held IBNR reserves in the amount of \$5,291,678 and \$4,944,090 on a gross basis and \$2,294,540 and \$2,314,418 on a net basis at December 31, 2009 and 2008, respectively.

The Company held \$933,825 and \$872,486 on a gross basis and \$404,919 and \$408,427 on a net basis for future allocated loss adjustment expenses related to environmental exposure (including coverage dispute costs) at December 31, 2009 and 2008, respectively.

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Notes to Statutory Financial Statements
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(9) Investment in Mt. Hawley

Condensed financial information for Mt. Hawley on a statutory basis is summarized below:

	<u>2009</u>	<u>2008</u>
Balance sheet at December 31:		
Assets	\$ 1,097,605,316	1,052,280,349
Liabilities	<u>(532,050,277)</u>	<u>(582,170,917)</u>
Total capital and surplus	<u>\$ 565,555,039</u>	<u>470,109,432</u>
Results of operations for the year ended December 31:		
Premium earned	\$ 213,828,935	263,005,386
Losses and underwriting expenses	<u>146,900,887</u>	<u>209,825,619</u>
Underwriting income	66,928,048	53,179,767
Investment income, including realized gains and losses net of tax	38,685,125	27,937,178
Other income	<u>153,589</u>	<u>179,368</u>
Income before federal income taxes	105,766,762	81,296,313
Federal income tax expense	<u>19,531,566</u>	<u>35,116,809</u>
Net income	<u>\$ 86,235,196</u>	<u>46,179,504</u>

(10) Federal Income Taxes

The Company adopted SSAP No. 10R effective December 31, 2009. The December 31, 2009 balances and related disclosures are calculated and presented pursuant to SSAP No. 10R. The December 31, 2008 balances and related disclosures are calculated and presented pursuant to SSAP No. 10 prior to its modifications by SSAP No. 10R.

The net deferred tax asset (DTA) decreased \$12.3 million from 2008 to \$6.1 million at year-end 2009. This change was mainly attributable to current year increases on unrealized gains in the Company's equity portfolio. The application of SSAP No. 10R, which the Company elected to apply in admitting deferred tax assets, did not have an impact on the Company's admitted assets or surplus for the year ended December 31, 2009.

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The net deferred tax assets at December 31, 2009 and the change from prior year are comprised of the following components:

	2009			2008 (Using SSAP10 Calc)	
	Total	Capital	Ordinary	Total	Change
Total of gross deferred tax assets	\$ 34,189,292	94,491	34,094,801	35,444,057	(1,254,765)
Valuation allowance adjustment	—	—	—	—	—
Adjusted gross deferred tax assets	34,189,292	94,491	34,094,801	35,444,057	(1,254,765)
Total gross deferred tax liabilities	28,134,263	27,930,688	203,575	17,080,914	11,053,349
Net deferred tax assets (liabilities)	6,055,029	(27,836,197)	33,891,226	18,363,143	(12,308,114)
Total deferred tax assets nonadmitted	—	—	—	—	—
Net admitted deferred tax assets (liabilities)	\$ 6,055,029	(27,836,197)	33,891,226	18,363,143	(12,308,114)
Net change in total DTAs nonadmitted	\$ —				

The amount of admitted adjusted gross DTAs admitted under each component of SSAP No. 10R is as follows:

	2009			2008 (Using SSAP10 Calc)	
	Total	Capital	Ordinary	Total	Change
Admitted under paragraph 10.a.	\$ 15,567,119	94,491	15,472,628	20,467,381	(4,900,262)
Admitted under paragraph 10.b.i.	—	—	—	—	—
Admitted under paragraph 10.b.ii.	—	—	—	—	—
Admitted under paragraph 10.c.	18,622,173	—	18,622,173	14,976,676	3,645,497
Admitted under admissibility test	\$ 34,189,292	94,491	34,094,801	35,444,057	(1,254,765)

The Company's risk-based capital level used for purposes of paragraph 10.d. is based on authorized control level risk-based capital of \$49,213,425 and total adjusted capital of \$784,160,848.

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Notes to Statutory Financial Statements

December 31, 2009 and 2008

The amount of admitted DTAs, admitted assets, statutory surplus and total adjusted capital in the risk-based capital calculation and the increased amount of DTAs, admitted assets and surplus as the result of the application of paragraph 10.e. is as follows:

		2009		2008 (Using SSAP 10 Calc)
	With election of SSAP10R	Increase due to SSAP10R	Prior to to SSAP10R	Prior to to SSAP10R
Total DTAs admitted	\$ 6,055,029	—	6,055,029	18,363,143
Total admitted assets	1,426,811,031	—	1,426,811,031	1,279,073,667
Statutory surplus	784,160,848	—	784,160,848	678,041,169
Total adjusted capital	784,160,848	—	784,160,848	—

The change in deferred income taxes reported in surplus before consideration on nonadmitted assets is comprised of the following components:

	2009	2008	Change
Total deferred tax assets	\$ 34,189,292	35,444,057	(1,254,765)
Valuation allowance adjustment	—	—	—
Total adjusted deferred tax assets	34,189,292	35,444,057	(1,254,765)
Total gross deferred tax liabilities	28,134,263	17,080,914	11,053,349
Net adjusted deferred tax assets	\$ <u>6,055,029</u>	<u>18,363,143</u>	(12,308,114)
Tax effect of unrealized gains (losses)			11,276,178
Change in net deferred income tax			\$ <u>(1,031,936)</u>

There are no temporary differences for which deferred tax liabilities are not recognized, except for investments in wholly-owned subsidiaries which are not required to be recognized under SSAP No. 10R.

Current income taxes incurred consists of the following significant components:

	2009	2008
Federal	\$ 13,521,562	20,921,262
Federal income tax benefit on net capital loss	(3,597,036)	(6,965,037)
Federal income tax incurred	\$ <u>9,924,526</u>	<u>13,956,225</u>

RLI INSURANCE COMPANY
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Deferred income tax assets and liabilities consist of the following major components:

		December 31	
		2009	2008
Deferred tax assets:			
Loss reserves	\$	12,295,880	11,965,982
Unearned premium reserve		10,744,558	10,412,895
Agents balances and other nonadmitted assets		3,371,487	3,841,404
Accrued expenses		262,500	262,500
Deferred compensation		7,306,670	5,427,637
Impairments on investments		94,491	3,368,361
Other		113,706	165,278
Total deferred tax assets		34,189,292	35,444,057
Nonadmitted deferred tax assets		—	—
Admitted deferred tax assets		34,189,292	35,444,057
Deferred tax liabilities:			
Unrealized gains		20,983,257	9,707,079
Intercompany transactions		6,356,103	6,356,103
Investments		91,178	115,192
Investment income		65,617	152,637
Depreciable assets		36,013	124,716
Other		602,095	625,187
Total deferred tax liabilities		28,134,263	17,080,914
Net deferred tax assets	\$	6,055,029	18,363,143

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The Company's income tax incurred and change in deferred income tax differs from the amount obtained by applying the federal statutory rate of 35% to income before income taxes as follows:

	<u>2009</u>	<u>2008</u>
Income before taxes, which includes net realized capital gains (losses)	\$ 38,872,246	40,670,759
Income tax expense at 35% statutory rate	13,605,286	14,234,766
Increase (decrease) in tax resulting from:		
Dividends received deduction	(1,008,847)	(1,206,701)
Nondeductible expenses	130,069	141,474
Tax-exempt income	(1,602,816)	(2,168,849)
Tax settlement	—	1,334,745
Other	(167,230)	847,641
Total statutory income taxes	<u>\$ 10,956,462</u>	<u>13,183,076</u>
Current income taxes incurred	\$ 13,521,562	20,921,262
Change in deferred income tax (without tax on unrealized gains and losses)	1,031,936	(773,149)
Tax on net realized capital losses	<u>(3,597,036)</u>	<u>(6,965,037)</u>
Total statutory income taxes	<u>\$ 10,956,462</u>	<u>13,183,076</u>

A reconciliation of federal income tax expense, computed by applying the statutory federal income tax rate of 35% in 2009 and 2008 to income before federal income taxes, which includes net realized capital gains, to the income tax expense shown in the accompanying statutory financial statements is as follows:

	<u>2009</u>	<u>2008</u>
Computed "expected" tax expense	\$ 13,605,286	14,234,766
Tax-exempt interest	(1,602,816)	(2,168,849)
Dividends received deduction	(1,008,847)	(1,206,701)
Discounting of liability for losses and loss adjustment expenses	329,898	(825,850)
Change in unearned premiums	331,663	638,159
Tax on net realized capital losses	3,597,036	6,965,037
Other	<u>(1,730,658)</u>	<u>3,284,700</u>
Federal income tax expense	<u>\$ 13,521,562</u>	<u>20,921,262</u>

As of December 31, 2009, the Company had no operating loss carryforwards available to offset future net income subject to federal income tax.

Income taxes incurred in current and prior years that will be available for recoupment in the event of future net losses are \$17,703,746 for 2009 and \$8,941,946 for 2008.

RLI INSURANCE COMPANY

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December 31, 2009 and 2008

(11) Employee Benefits

The Company, along with its affiliates and ultimate parent, maintains an Employee Stock Ownership Plan (ESOP), 401(k), and bonus and incentive plans covering executives, managers, and associates. At the discretion of the Board of Directors, funding of these plans is primarily dependent upon reaching predetermined levels of operating return on equity and Market Value Potential (MVP). MVP is a compensation model that measures comprehensive earnings against a minimum required return on the Company's capital. Bonuses are earned as the Company generates earnings in excess of this required return. While some management incentive plans may be affected somewhat by other performance factors, the larger influence is corporate performance. The Company's 401(k) plan allows voluntary contributions by employees and permits ESOP diversification transfers for employees meeting certain age or service requirements. The Company provides a basic 401(k) contribution of 3% of eligible compensation. Participants are 100% vested in both voluntary and basic contributions. Additionally, an annual discretionary profit-sharing contribution may be made to the ESOP and 401(k), subject to the achievement of certain overall financial goals. For plan years prior to 2007, profit-sharing contributions were subject to a five-year cliff vest. For plan year 2007 and later, contributions vest after three years of service. The Company's ESOP and 401(k) cover all employees meeting eligibility requirements. ESOP and 401(k) profit-sharing contributions are determined annually by the board of directors and are expensed in the year earned. The total amount of expense for these plans for 2009 and 2008 was \$8.7 million and \$8.8 million, respectively. The Company allocates a portion of this expense to its subsidiaries per the terms of the intercompany services agreement. The Company's total expenditures for employee benefits, including ESOP and 401(k) contributions but excluding the cost of incentive plans discussed below, were \$11.2 million and \$9.2 million for 2009 and 2008, respectively.

Annual bonuses are awarded to executives, managers, and associates through the Company's incentive plans, provided certain financial and operational goals are met. The total amount of expense for these incentive plans for 2009 and 2008 was \$15.5 million and \$4.6 million, respectively. The Company allocates a portion of this expense to its subsidiaries per the terms of the intercompany services agreement.

In 2002, the Company, along with its affiliates and ultimate parent, began offering certain eligible employees postemployment medical coverage. Under the Company's plan, employees who retire at age 55 or older with 20 or more years of company service may continue medical coverage under the Company's health plan. Employees who elect continuation of coverage pay the full COBRA (Consolidated Omnibus Budget Reconciliation Act of 1985) rate and coverage terminates upon reaching age 65. The Company expects a relatively small number of employees will become eligible for this benefit. The COBRA rate established for participating employees covers the cost of providing this coverage. The Company does not provide compensated absences.

(12) Commitments and Contingent Liabilities

The Company has an accrual for assessments at December 31, 2009 and 2008 of \$3.2 million and \$2.7 million, respectively. It is not possible at this time to determine the periods over which the assessments are expected to be paid.

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December 31, 2009 and 2008

The Company is party to numerous claims and losses that arise in the normal course of business. Many of such claims or losses involve claims under policies that the Company underwrites as an insurer. The Company believes that the resolution of these claims and losses will not have a material adverse effect on its financial condition, results of operations or cash flows. The Company is also involved in various other legal proceedings and litigation unrelated to its insurance business that arise in the ordinary course of business operations. The Company believes that any liabilities that may arise as a result of these legal matters will not have a material adverse effect on its financial condition or operating results.

(13) Leases

The Company leases regional office facilities and computers under operating leases. These leases expire in various years through 2014. Minimum future rental payments under noncancelable leases are as follows:

2010	\$	2,784,799
2011		3,146,334
2012		2,949,496
2013		1,995,443
2014		<u>4,823,885</u>
Total minimum future rental payments		\$ <u><u>15,699,957</u></u>

The Company shares rental expense with its affiliate, Mt. Hawley, through an intercompany cost sharing agreement. The Company's portion of rental expense for 2009 and 2008 was \$0.9 million.

(14) Subsequent Events

The Company has evaluated subsequent events through May 25, 2010, the date the accompanying financial statements – statutory basis were available to be issued. During the first quarter of 2010, the IRS began an examination of our consolidated federal income tax returns and capital loss carryback claims. The years under examination are 2005 through 2009.

RLI INSURANCE COMPANY
Schedule of Supplemental Investment Risk Interrogatories
December 31, 2009

Schedule 1

1) Total admitted assets: \$ 1,426,811,031

2) 10 largest exposures to a single issuer/borrower/investment:

Issuer	Amount	Percentage
Mt. Hawley Insurance Company	\$ 565,555,039	39.6%
iShares Russel 1000 Index	13,028,375	0.9
JP Morgan Chase & Co	9,211,338	0.6
JP Morgan Chase Commercial Mortgage	7,265,731	0.5
Goldman Sachs Group Inc	6,636,829	0.5
General Electric Corp	6,368,156	0.4
Wells Fargo Co	6,119,023	0.4
MSDW Capital I	5,671,842	0.4
Deere & Co	5,589,174	0.4
Maryland State	5,432,791	0.4

3) Total admitted assets held in bonds by NAIC rating:

Bonds	Amount	Percentage
NAIC-1	\$ 561,561,030	39.4%
NAIC-2	45,608,996	3.2
NAIC-3	1,967,500	0.1
NAIC-4	—	—
NAIC-5	—	—
NAIC-6	—	—

Preferred Stocks	Amount	Percentage
P/RP-1	\$ —	—%
P/RP-2	—	—
P/RP-3	—	—
P/RP-4	—	—
P/RP-5	—	—
P/RP-6	—	—

4) Assets held in foreign investments:

	Amount	Percentage
Total admitted assets held in foreign investments	\$ 30,866,429	2.2%
Foreign currency denominated investments	—	—
Insurance liabilities denominated in that same foreign currency	—	—

5) Assets held in foreign investments represent less than 2.5% of the reporting entity's total admitted assets; therefore, detail not required for interrogatories 5 – 10.

11) Assets held in Canadian investments and unhedged Canadian currency exposure are less than 2.5% of the reporting entity's total admitted assets; therefore, detail not required.

12) There were no admitted assets held in investments with contractual sales restrictions.

13) Admitted assets held in the largest 10 equity interests:

Issuer	Amount	Percentage
Mt. Hawley Insurance Company	\$ 565,555,039	39.6%
iShares Russel 1000 Index	13,028,375	0.9
AT&T Inc	4,645,973	0.3
JP Morgan Chase & Co	4,499,110	0.3
Spdr Trust Series 1	4,123,280	0.3
Utilities Select Sector Spdr	4,113,252	0.3
Dominion Resources Inc	3,674,048	0.3
Exxon Mobil Corporation	3,557,472	0.2
Deere & Co	3,407,670	0.2
Hewlett-Packard Co	3,348,150	0.2

14) There were no assets held in nonaffiliated, privately placed equities, exceeding 2.5% of the Company's total admitted assets.

RLI INSURANCE COMPANY
Schedule of Supplemental Investment Risk Interrogatories
December 31, 2009

- 15) There were no admitted assets held in general partnership interests that exceeded 2.5% of the Company's total admitted assets.
- 16) There were no mortgage loans reported on the Company's Annual Statement Schedule B, therefore, detail not required for interrogatories 16 and 17.
- 18) Assets held in each of the five largest investments in one parcel or group of contiguous parcels of real estate reported in the Annual Statement Schedule A were less than 2.5% of the reporting entity's total admitted assets; therefore, detail not required for interrogatory 18.
- 19) There were no admitted assets held in investments held in mezzanine real estate loans.
- 20) Total admitted assets subject to the following types of agreements:

Agreement type	At year-end		At end of each quarter		
	Amount	Percentage	1st Qtr	2nd Qtr	3rd Qtr
Securities lending	\$	—%	\$ 3,534,903		
Repurchase		—			
Reverse repurchase		—			
Dollar repurchase		—			
Dollar reverse repurchase		—			

- 21) The Company owns no warrants not attached to other financial instruments, options, caps, and floors.
- 22) The Company has no exposure to collars, swaps, or forwards.
- 23) The Company has no exposure for future contracts.

See accompanying independent auditors' report.

RLI INSURANCE COMPANY

Summary Investment Schedule

December 31, 2009

Investment categories	Gross investment holdings		Admitted assets as reported in the annual statement	
Bonds:				
U.S. Treasury securities	\$ 158,016	0.01%	\$ 158,016	0.01%
U.S. government agency and corporate obligations:				
Issued by U.S. government agencies	1,942,650	0.14	1,942,650	0.14
Issued by U.S. government-sponsored agencies	140,687,793	10.31	140,687,793	10.33
Non-U.S. government	472,430	0.03	472,430	0.03
Foreign government:				
Securities issued by states, territories, and political subdivisions in the U.S.:				
State, territory, and possession and general obligations	19,441,593	1.42	19,441,593	1.43
Political subdivisions of states, territories, and possessions' political subdivisions' general obligations	47,204,148	3.46	47,204,148	3.47
Revenue and assessment obligations	59,997,709	4.40	59,997,709	4.40
Industrial development and similar obligations	—	—	—	—
Mortgage-backed securities:				
Pass-through securities:				
Guaranteed by GNMA	13,345,977	0.98	13,345,977	0.98
Issued by FNMA and FHLMC	62,826,685	4.60	62,826,685	4.61
All other	—	—	—	—
CMOs and REMICs:				
Issued by FNMA, FHLMC, GNMA, or VA	12,523,979	0.92	12,523,979	0.92
Issued by non-U.S. government issuers and collateralized by mortgage-backed securities issued or guaranteed by above agencies	—	—	—	—
All other	16,398,933	1.20	16,398,933	1.20
Other debt and other fixed income securities:				
Unaffiliated domestic securities	149,905,679	10.99	149,905,679	11.01
Unaffiliated foreign securities	30,866,429	2.26	30,866,429	2.27
Affiliated securities	—	—	—	—
Equity interests:				
Investments in mutual funds	—	—	—	—
Preferred stocks:				
Affiliated	—	—	—	—
Unaffiliated	—	—	—	—
Publicly traded equity securities:				
Affiliated	—	—	—	—
Unaffiliated	176,733,568	12.95	176,733,568	12.98
Tangible personal property under lease:				
Affiliated	—	—	—	—
Unaffiliated	—	—	—	—
Other equity securities:				
Affiliated	568,001,446	41.63	565,555,039	41.52
Unaffiliated	—	—	—	—
Mortgage loans:				
Construction and land development	—	—	—	—
Agricultural	—	—	—	—
Single-family residential properties	—	—	—	—
Multifamily residential properties	—	—	—	—
Commercial loans	—	—	—	—
Mezzanine real estate loans	—	—	—	—

RLI INSURANCE COMPANY

Summary Investment Schedule

December 31, 2009

Investment categories	Gross investment holdings		Admitted assets as reported in the annual statement	
Real estate investments:				
Property occupied by company	\$ 8,497,635	0.62	\$ 8,270,113	0.61
Property held for production of income	—	—	—	—
Property held for sale	—	—	—	—
Policy loans	—	—	—	—
Receivable for securities				
Cash and short-term investments	54,727,963	4.01	54,727,963	4.02
Write-in invested assets	1,000,000	0.07	1,000,000	0.07
Total invested assets	<u>\$ 1,364,732,633</u>	<u>100.00%</u>	<u>\$ 1,362,058,704</u>	<u>100.00%</u>

See accompanying independent auditors' report.

RLI INSURANCE COMPANY

Supplemental Schedule of Reinsurance Interrogatories

Year ended December 31, 2009

- 7.1 Has the reporting entity reinsured any risk with any other entity under a quota share reinsurance contract that includes a provision that would limit the reinsurer's losses below the stated quota share percentage (e.g., a deductible, a loss ratio corridor, a loss cap, an aggregate limit, or any similar provisions)? Yes ☐ No ☒
- 7.2 If yes, indicate the number of reinsurance contracts containing such provisions. N/A ☒
- 7.3 If yes, does the amount of reinsurance credit taken reflect the reduction in quota share coverage caused by any applicable limiting provision(s)? Yes ☐ No ☐ N/A ☒
- 8.1 Has this reporting entity reinsured any risk with any other entity and agreed to release such entity from liability, in whole or in part, from any loss that may occur on this risk, or portion thereof, reinsured? Yes ☒ No ☐
- 8.2 If yes, give full information.
Reinsurance agreements with Seaton Insurance Company and Gerling, which were in runoff, were commuted during 2009.
- 9.1 Has the reporting entity ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which during the period covered by the statement: (i) it recorded a positive or negative underwriting result greater than 3% of prior year-end surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 3% of prior year-end surplus as regards policyholders; (ii) it accounted for that contract as reinsurance and not as a deposit; and (iii) the contract(s) contain one or more of the following features or other features that would have similar results:
- (a) A contract term longer than two years and the contract is noncancelable by the reporting entity during the contract term;
 - (b) A limited or conditional cancellation provision under which cancellation triggers an obligation by the reporting entity, or an affiliate of the reporting entity, to enter into a new reinsurance contract with the reinsurer, or an affiliate of the reinsurer;
 - (c) Aggregate stop loss reinsurance coverage;
 - (d) An unconditional or unilateral right by either party to commute the reinsurance contract except for such provisions, which are only triggered by a decline in the credit status of the other party;
 - (e) A provision permitting reporting of losses, or payment of losses, less frequently than on a quarterly basis (unless there is no activity during the period); or
 - (f) Payment schedule, accumulating retentions from multiple years, or any features inherently designed to delay timing of the reimbursement to the ceding entity
- Yes ☐ No ☒

RLI INSURANCE COMPANY

Supplemental Schedule of Reinsurance Interrogatories

Year ended December 31, 2009

- 9.2 Has the reporting entity during the period covered by the statement ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates), excluding cessions to approved pooling arrangements or to captive insurance companies that are directly or indirectly controlling, controlled by, or under common control with (i) one or more unaffiliated policyholders of the reporting entity or (ii) an association of which one or more unaffiliated policyholders of the reporting entity is a member where:
- (a) The written premium ceded to the reinsurer by the reporting entity or its affiliates represents fifty percent (50%) or more of the entire direct and assumed premium written by the reinsurer based on its most recently available financial statement; or
- (b) Twenty-five percent (25%) or more of the written premium ceded to the reinsurer has been retroceded back to the reporting entity or its affiliates
- Yes ☐ No ☒
- 9.3 If yes to 9.1 or 9.2, please provide the following information in the Reinsurance Summary Supplemental Filing for general interrogatory 9:
- (a) The aggregate financial statement impact gross of all such ceded reinsurance contracts on the balance sheet and statement of income;
- (b) A summary of the reinsurance contract terms and indicate whether it applies to the contracts meeting the criteria in 9.1 or 9.2; and
- (c) A brief discussion of management's principal objectives in entering into the reinsurance contract including the economic purpose to be achieved.
- N/A ☒
- 9.4 Except for transactions meeting the requirements of paragraph 30 of SSAP No. 62, *Property and Casualty Reinsurance*, has the reporting entity ceded any risk under any reinsurance contract (or multiple contracts with the same reinsurer or its affiliates) during the period covered by the financial statement, and either:
- (a) Accounted for that contract as reinsurance (either prospective or retroactive) under statutory accounting principles (SAP) and as a deposit under generally accepted accounting principles (GAAP); or
- (b) Accounted for that contract as reinsurance under GAAP and as a deposit under SAP?
- Yes ☐ No ☒
- 9.5 If yes to 9.4, explain in the Reinsurance Summary Supplemental Filing for general interrogatory 9 (section D) why the contract(s) is treated differently for GAAP and SAP.
- N/A ☒
- 9.6 The reporting entity is exempt from the Reinsurance Attestation Supplement under one or more of the following criteria:
- (a) The entity does not utilize reinsurance; or
- (b) The entity only engages in a 100% quota share contract with an affiliate or lead company has filed an attestation supplement; or
- (c) The entity has no external cessions and only participates in an intercompany pool and the affiliated lead company has filed an attestation supplement.
- Yes ☐ No ☒

See accompanying independent auditors' report.